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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 768

WILLIAM J. SULLIVAN AND GEORGIA K. SULLIVAN,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

In February 1948, petitioner owned all the stock of a corporation which was in the automobile and financing business. At that time the corporation hired Nelson as manager and petitioner contracted to sell Nelson up to 40 percent of the corporation's stock. Nelson actually purchased 114 shares or 38 percent of the stock. The written contract between petitioner and Nelson provided (1) that petitioner would repurchase Nelson's stock at book value whenever Nelson so requested, and (2) that Nelson would resell the stock to petitioner at book value when he left the corporation's employ. In 1956 Nelson decided to go

into business for himself, and, pursuant to the terms of the 1948 contract, he requested petitioner to repurchase the corporation's stock from him at book value, which was then approximately $198,000. Petitioner thereupon informed Nelson that the corporation would acquire the stock from him at the contract price, and the corporation did so. (Pet. A20–A33.)

The Commissioner asserted a deficiency against petitioner on the ground that he was unconditionally obligated to purchase Nelson's stock for $198,000 so that when the corporation relieved him of this personal obligation by paying $198,000 out of corporate earnings, petitioner received a dividend of this amount. The district court upheld the government's position. It held (1) that Nelson's 1956 request that petitioner repurchase the 114 shares created "an unconditional primary obligation" on Sullivan to pay Nelson $198,000 for the stock (Pet. A39; see also Pet. A36, A42), (2) that there was "no * * * business purpose" for "causing the corporation [rather than petitioner] to purchase Nelson's stock" (Pet. A48), (3) that the "only purpose apparent from the record" for "using [$198,000 of] accumulated corporate profits to discharge the [petitioner's] primary liability" "was to minimize [petitioner's] income taxes" (Pet. A48), and (4) that petitioner realized an "economic benefit" from "the discharge by the corporation, with the use of undistributed corporate earnings, of his private obligation to purchase Nelson's stock" (Pet. A48–A49). The court of appeals affirmed, stating that there was "no corporate business purpose" for shifting the obligation to the corporation and that the

corporation's action in using $198,000 of accumulated corporate earnings to relieve petitioner "of his personal obligation" was thus "the equivalent of a dividend" (363 F. 2d 724, 729).

1. The decisions below are correct. Petitioner was primarily and unconditionally obligated to pay Nelson $198,000 for 114 shares of the corporation's stock. If petitioner had performed his contract obligation, he would have been out of pocket $198,000 cash and would have owned 100 percent of the corporation's stock. By directing his corporation to perform the contract in his place, petitioner ended up with $198,000 more cash in his pocket than if he had performed, and he still owned 100 percent of the stock.

Petitioner points out that although he saved $198,000 by causing the corporation to perform his obligation, the corporation was worth $198,000 less than it would have been if petitioner had paid Nelson the purchase price, and thus that his net worth was not really affected by whether he or the corporation paid the $198,000. This is not, however, relevant to the question whether a shareholder has received a dividend. If a corporation paid its sole shareholder a $198,000 cash dividend, the value of the corporation's stock would drop in value by $198,000 at the same time that the shareholder's personal cash increased by the same amount. Although the shareholder's net worth would not increase at all, he would be taxed on a $198,000 dividend. This is because a dividend results when corporate assets are removed from the corporation and either paid to the shareholder or used to discharge his personal obligation,

i.e., when his net worth *apart from his stock in the corporation* increases.[1]

In the instant case the corporation paid $198,000 in discharge of petitioner's personal obligation. Thus, his net worth *apart from his stock in the corporation* increased by $198,000 because of the corporate payment, just at it would have if petitioner, after paying Nelson the $198,000, had later caused the corporation to distribute a dividend of $198,000 to reimburse him. This is what the lower courts meant when they concluded that the "transaction * * * resulted in an economic benefit to [petitioner] * * * because he was relieved of his personal obligation to purchase Nelson's stock" (363 F. 2d at 729; see also Pet. A48–A49).

Petitioner also argues that the instant transaction is different than a $198,000 dividend because petitioner divested himself of and the corporation acquired both the benefits and the burdens of the contract, *i.e.*, both the obligation to pay $198,000 and the right to receive 114 shares of stock. Petitioner, however, owned all the stock of the corporation (186 shares) other than Nelson's 114 shares. Therefore, regardless of whether petitioner or the corporation purchased Nelson's 114 shares, it is clear that after the purchase was completed petitioner would own 100

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[1] See, *e.g.*, *American Properties, Inc.* v. *Commissioner*, 28 T.C. 1100, affirmed *per curiam*, 262 F. 2d 150 (C.A. 9); *Greenspon* v. *Commissioner*, 229 F. 2d 947 (C.A. 8); *Sachs* v. *Commissioner*, 277 F. 2d 879 (C.A. 8); *Jaeger Motor Car Company* v. *Commissioner*, 284 F. 2d 127 (C.A. 7); *Challenge Mfg. Co.* v. *Commissioner*, 37 T.C. 650; Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (1966 ed.), pp. 165–173, 294–300. Cf. *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716.

percent of the outstanding stock of the corporation. In such circumstances, it could make no difference to petitioner whether his 100 percent ownership was represented by 186 shares or 300 shares.[2] Thus, there is no substance to petitioner's argument that he gave up something of value when he directed the corporation to acquire Nelson's 114 shares and that the corporation gained something of value when it acquired the stock. The only consequence of substance which followed from the assignment to the corporation of the contract "benefits" and "burdens" was that accumulated corporate earnings were used to discharge petitioner's $198,000 obligations to Nelson.

Petitioner argues that the instant decision is in conflict with *Commissioner* v. *Decker*, 286 F. 2d 427 (C.A. 6), affirming *per curiam* 32 T.C. 326. In *Decker*, five individuals, who owned all the stock of a corporation, had agreed that upon the death of a stockholder the survivors would buy his stock at book value. Two of the stockholders died, thus obligating the remaining three stockholders (the taxpayers) to purchase their stock. Because the corporation was "desirous of acquiring treasury stock that could be sold to key em-

[2] In somewhat similar circumstances the courts have long refused to cause tax significance to turn on the absence or presence of a transfer of stock between a corporation and its shareholders, since such a transfer would be no more than "a meaningless gesture." See *Davant* v. *Commissioner*, 366 F. 2d 874, 887 (C.A. 5), certiorari denied April 24, 1967, No. 911, this Term; see also, *e.g.*, *Liddon* v. *Commissioner*, 230 F. 2d 304 (C.A. 6), certiorari denied, 352 U.S. 824; *Commissioner* v. *Morgan*, 288 F. 2d 676 (C.A. 3), certiorari denied, 368 U.S. 836; *Heller* v. *Commissioner*, 2 T.C. 371, affirmed, 147 F. 2d 376 (C.A. 9), certiorari denied, 325 U.S. 868.

ployees" (32 T.C. at 331), it, rather than the taxpayers, purchased the stock of the two deceased stockholders.* The Commissioner argued there, as he did here, that the corporation, by discharging the stockholders' personal obligations, had paid a dividend to them. The Tax Court rejected this argument, stressing its finding that "there was a sound business reason for the corporation to acquire the stock," because the corporation needed the stock to satisfy certain of its employees who had taken "the initiative in seeking to obtain some of the stock of the company" (32 T.C. at 333). The Sixth Circuit affirmed *per curiam* (286 F. 2d 427).

In the instant case, on the other hand, both lower courts concluded that there was "no corporate business purpose" for causing petitioner's obligation to Nelson to be satisfied out of accumulated corporate earnings (363 F. 2d 729; Pet. A48), but that this route was used "to minimize [petitioner's] income taxes" (Pet. A48). Similarly, in *Schalk Chemical Co.* v. *Commissioner*, 304 F. 2d 48 (C.A. 9), where two stockholders contracted to buy out a third and then had their corporation perform the contract, the Ninth Circuit upheld the Commissioner's imposition of dividend treatment on the two shareholders whose obligations were satisfied by their corporation, distinguishing *Decker* on the ground that there "the corporate payments were for the benefit of the cor-

*In form, the taxpayers purchased the stock from the two deceased shareholders and sold it to the corporation, but the court found that they acted as agents of the corporation in carrying out the purchase.

poration and not the stockholders; here the finding is just the opposite—it was the shareholders not the corporation that derived the benefit of those payments" (304 F. 2d at 52–53).

The Commissioner does not agree with this distinction, but rather believes that whenever a shareholder, who is primarily obligated to purchase the stock of a retiring shareholder, causes his corporation to satisfy his obligation by redeeming the shares, the continuing shareholder receives a dividend.[4] There is no direct conflict among the circuits, however. For the Sixth Circuit rejected the Commissioner's position in *Decker* where "there was a sound business reason for the corporation to acquire the stock" (32 T.C. at 333), and the Eighth and Ninth Circuits upheld the Commissioner's position in the instant case and *Schalk Chemical* where there was "no corporate business purpose" (363 F. 2d at 729) for the corporation to acquire the stock. Although the Tax Court decision in *Decker*, which was affirmed *per curiam* by the Sixth Circuit, contains some language (32 T.C. at 332–333) which is inconsistent with the results reached by the Eighth and Ninth Circuits, there is no assurance that the Sixth Circuit would have decided this case—where there is no business purpose—any differently than the Eighth Circuit did.[5]

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[4] Although the Commissioner initially acquiesced in the "result" reached in the *Decker* case (1964–2 Cum. Bull. 5), he is now reexamining his acquiescence.

[5] Contrary to petitioner's contentions, the instant decision is not in conflict with cases such as *Holsey* v. *Commissioner*, 258 F. 2d 865 (C.A. 3), and *S. K. Ames, Inc.* v. *Commissioner*, 16 B.T.A. 1020, and administrative rulings such as Rev. Rul. 58-614,

2. Next petitioner contends that although the clear language of the written contract unconditionally obligated him to purchase Nelson's stock (Pet. A39, A42; 363 F. 2d at 726–728), the district court erred in refusing to consider parol evidence that the parties to the 1948 contract never intended that petitioner would be obligated to repurchase the stock but rather that they intended the corporation to be the party so obligated (Pet. 16–22). The courts below correctly held that where (as here) the written contract is unambiguous, its clear terms fix the rights of the parties and may not be altered by parol evidence—whether the opposing litigants are the parties to the contract or the Commissioner and one of the parties to the contract (Pet. A36–A39; 363 F. 2d at 726–727). The tax consequences of the instant transaction depend upon whether petitioner was unconditionally obligated to purchase Nelson's stock on demand, and this in turn depends upon whether Nelson could have established, through litigation if necessary, that such obligation existed. Since the parol evidence rule would unquestionably have applied in any litigation between Nelson and petitioner on this question, the lower courts correctly applied it in the instant case in deciding whether petitioner was obligated to buy Nelson's stock on demand.

Contrary to petitioner's contention (Pet. 19), the trend of the more recent decisions has been to reject

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1958–2 Cum. Bull. 920, and Rev. Rul. 59–286, 1959–2 Cum. Bull. 103, in which (unlike the instant case) the taxpayer-shareholder was not unconditionally obligated to purchase the retiring shareholder's stock.

the conceptual argument which had earlier led some courts to hold that one who is not a party to a contract may not invoke the parol evidence rule. Petitioner cites decisions of, *inter alia,* the Courts of Appeals for the Second, Fifth, Eighth and Ninth Circuits (Pet. 19–20), all of which have since adopted the more modern approach. See, *e.g., Clark* v. *United States,* 341 F. 2d 691, 693 (C.A. 9); *Great American Ins. Co. N.Y.* v. *Gulf Marine Drilling No. 1,* 302 F. 2d 332, 334–335 (C.A. 5); *Commissioner* v. *Dwight's Estate,* 205 F. 2d 298 (C.A. 2). And the Eighth Circuit reached the result it did in the instant case (363 F. 2d at 727) with full awareness of its earlier decisions cited by petitioner (Pet. 19). Moreover, the leading authorities in the field of evidence have uniformly pointed out the conceptual error in the earlier cases. See IX Wifimore on *Evidence,* § 2446, pp. 149–159; 3 Corbin on *Contracts,* § 596, pp. 572, 574–576; 3 Jones on *Evidence* (2d ed.), § 1489, p. 2710; 4 Williston on *Contracts* (3d ed.), § 647.[6]

3. Finally, petitioner argues that even if he was unconditionally obligated to purchase Nelson's stock on demand so that he received a $198,000 distribution from the corporation when it performed his obliga-

[6] Nor is there any conflict (Pet. 19) with the holding of this Court in *Miller* v. *Robertson,* 266 U.S. 243. The question in that case was whether a contract for the sale of all the ore under the control of the seller covered ore under the control of the seller's subsidiary. Since the contract there in question was silent on the point, this Court looked to extrinsic evidence. Thus the case has no relevance to the instant case where petitioner argues that parol evidence should be used to contradict the clear and unambiguous provisions of the written contract.

tion, this distribution is nevertheless not taxable to him as a dividend. Petitioner argues that the distribution qualifies for capital gain treatment as a "partial liquidation" under Code § 346(b), because shortly after the corporation paid out the $198,000 for Nelson's stock, it sold one of its two businesses—the automobile dealership—for approximately $100,000 and retained the finance business. However, § 346(b) applies only where a corporation, which has conducted two businesses for more than five years, distributes to its shareholders in redemption of their stock either the assets of one of the two businesses "in kind" or "the proceeds" from the sale of one of the two businesses. S. Rep. No. 1622, 83d Cong., 2d Sess., p. 262; see also H. Rep. No. 1337, 83d Cong., 2d Sess., p. A112. Thus, § 346(b) explicitly provides that it applies only to a "distribution [which] is *attributable* to the corporation's ceasing to conduct [a trade or business], or [which] consists of the assets of a trade or business" (emphasis added). The distribution of $198,000 was, however, made before the corporation decided to sell its automobile dealership (R. 81, 103–104).[7] Therefore, it clearly was not in any way "attributable" to the sale of the dealership, and the petitioner's argument is without merit.[8]

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[7] "R." references are to the printed record in the court of appeals.

[8] The § 346(b) issue is essentially factual, there is no conflict of decisions on this point and no other reason for further review.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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